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ABSTRACT

This pamphlet defines "national debt," explains how the national debt is incurred by the federal government, and what deficits are. The sections of the pamphlet include: (1) "Definitions"; (2) "History"; (3) "Measurements"; (4) "Problems"; and (5) "Strategies." The text is written in a question-answer format with illustrations, graphs and charts to support the text. (EH)

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UNDERSTANDING THE FEDERAL DEBT AND DEFICIT

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Federal Reserve Bank of New York • Public Information Department

by Adam Gonnelli
Public Information Department
Federal Reserve Bank of New York

UNDERSTANDING THE FEDERAL DEBT AND DEFICIT

"A national debt, if it is not excessive, will be to us a national blessing."
—Alexander Hamilton, 1781

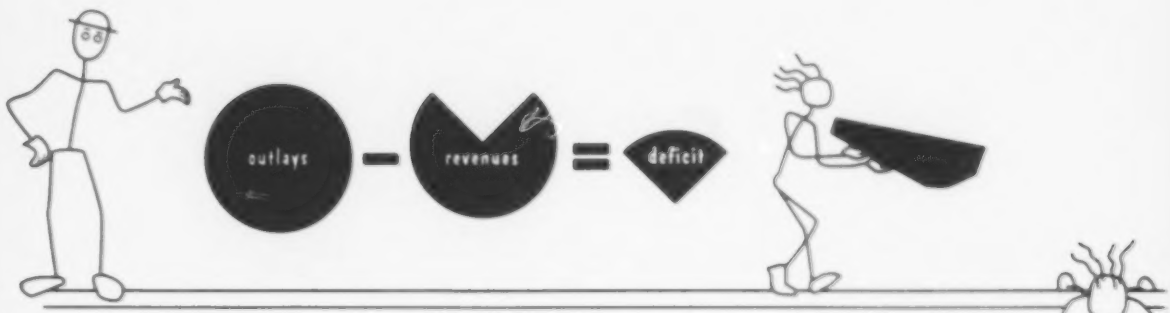
"For decades we have piled deficit upon deficit, mortgaging our future and our children's future for the temporary convenience of the present. To continue this long trend is to guarantee tremendous social, cultural, political and economic upheavals"
—Ronald Reagan, 1981

What precisely is the national debt?

It's the total amount of funds that the federal government has borrowed over the years and not yet repaid.

And what about the deficit?

That's the amount that the government spends each year in excess of what its tax, tariff, and fee revenues bring in. The government then must borrow to make up the difference. It's the accumulation of deficits year after year that makes up the total national debt.



Why do we have deficits?

Because the government makes commitments to spending programs without raising enough revenue to pay for them. Therefore, the government has to borrow.

How does the government borrow money? Does it just go to the bank?

No. The U.S. Treasury issues securities, or IOUs, such as savings bonds and Treasury bills, notes, and bonds. Lenders buy these securities and the money goes to the government. In return, the government pays interest to the owners of the securities.

What are Treasury bills...and those others?

They're the main tools that the U.S. government uses for borrowing. Treasury bills are issued with three-, six-, or 12-month maturities. Notes come due in two to 10 years, while bonds mature in more than 10 years.

Who determines how much interest is paid?

No one! Interest is the price of credit and, as in any competitive market, prices are determined by supply and demand. The Federal Reserve — the nation's central bank — auctions the securities on behalf of the U.S. Treasury. The securities go to the highest bidders.

So they get the highest interest rates?

No, just the opposite. The higher the price of a security, the lower its interest rate. The highest bidders, therefore, are those lenders willing to accept the lowest interest rates. The government wants to pay as little interest as possible, which is the purpose of holding the auctions.

Who are the "lenders"?

The lenders include banks, corporations, pension funds, private citizens, and government agencies, as well as foreign individuals and institutions. Anyone or any organization that buys securities from the Treasury is a lender.

How much money is borrowed?

The simple answer is, "Enough to cover the deficit." However, the process is a little more complicated. The Treasury issues new securities every week, both to pay off maturing securities and to raise new funds. But aren't you going to ask the big question...

If you insist! How large is the debt?

As of October 1, 1993, the *gross* federal debt was $4.35 trillion. But many people look at *net* debt, which excludes about $1 trillion of the gross debt that is held by various government accounts. Net debt, also referred to as publicly held debt, is a more accurate way to measure how much debt the U.S. government has to repay.

Why?

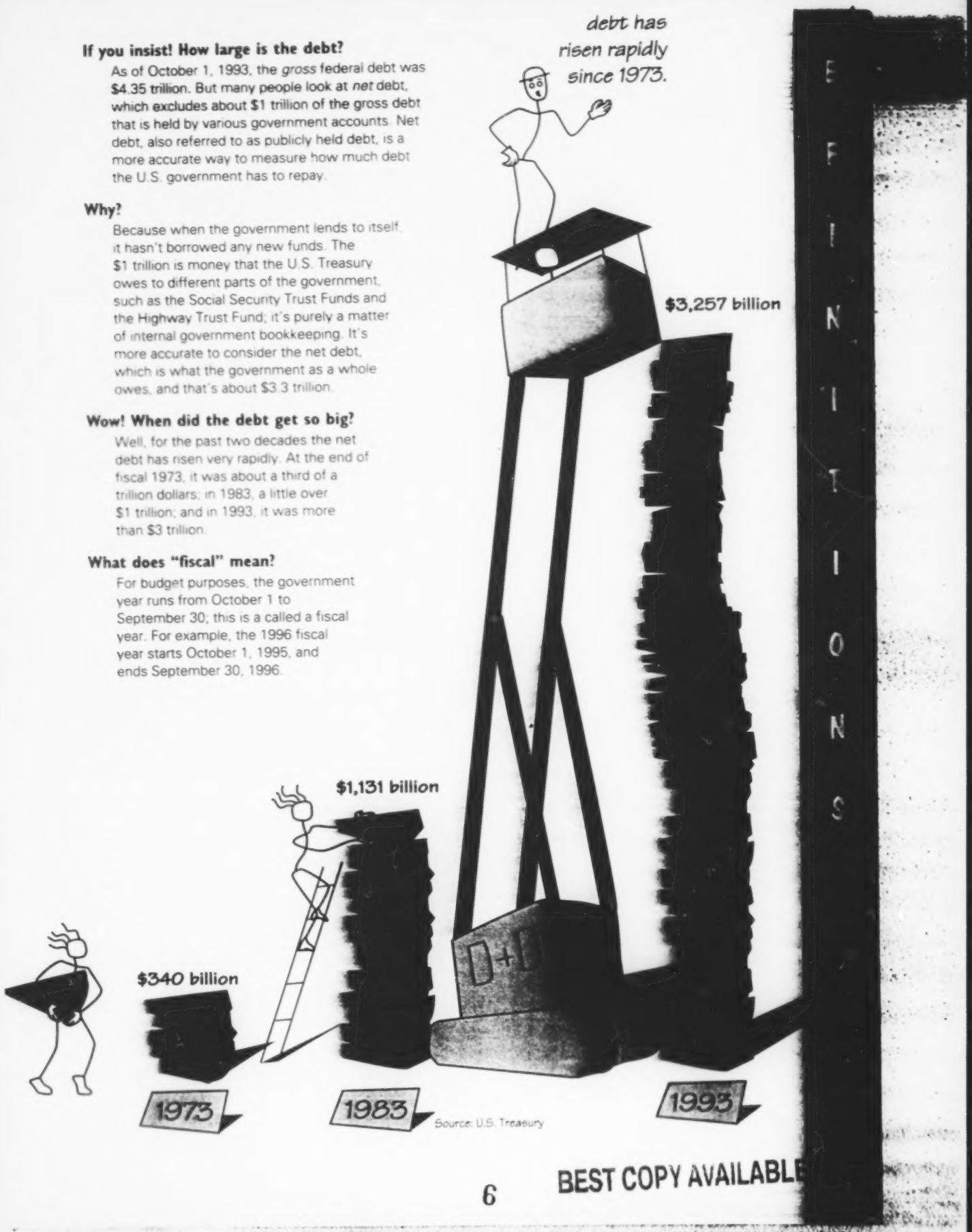
Because when the government lends to itself, it hasn't borrowed any new funds. The $1 trillion is money that the U.S. Treasury owes to different parts of the government, such as the Social Security Trust Funds and the Highway Trust Fund; it's purely a matter of internal government bookkeeping. It's more accurate to consider the net debt, which is what the government as a whole owes, and that's about $3.3 trillion.

Wow! When did the debt get so big?

Well, for the past two decades the net debt has risen very rapidly. At the end of fiscal 1973, it was about a third of a trillion dollars; in 1983, a little over $1 trillion; and in 1993, it was more than $3 trillion.

What does "fiscal" mean?

For budget purposes, the government year runs from October 1 to September 30; this is a called a fiscal year. For example, the 1996 fiscal year starts October 1, 1995, and ends September 30, 1996.



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So why the huge increase in the debt?

The government has been increasing its spending —particularly on such items as Social Security, Medicare, and, for a time, national defense — at a rate faster than revenues have been growing. Also, there is a snowball effect resulting from each increase in the debt: as the debt expands, so do the interest payments.

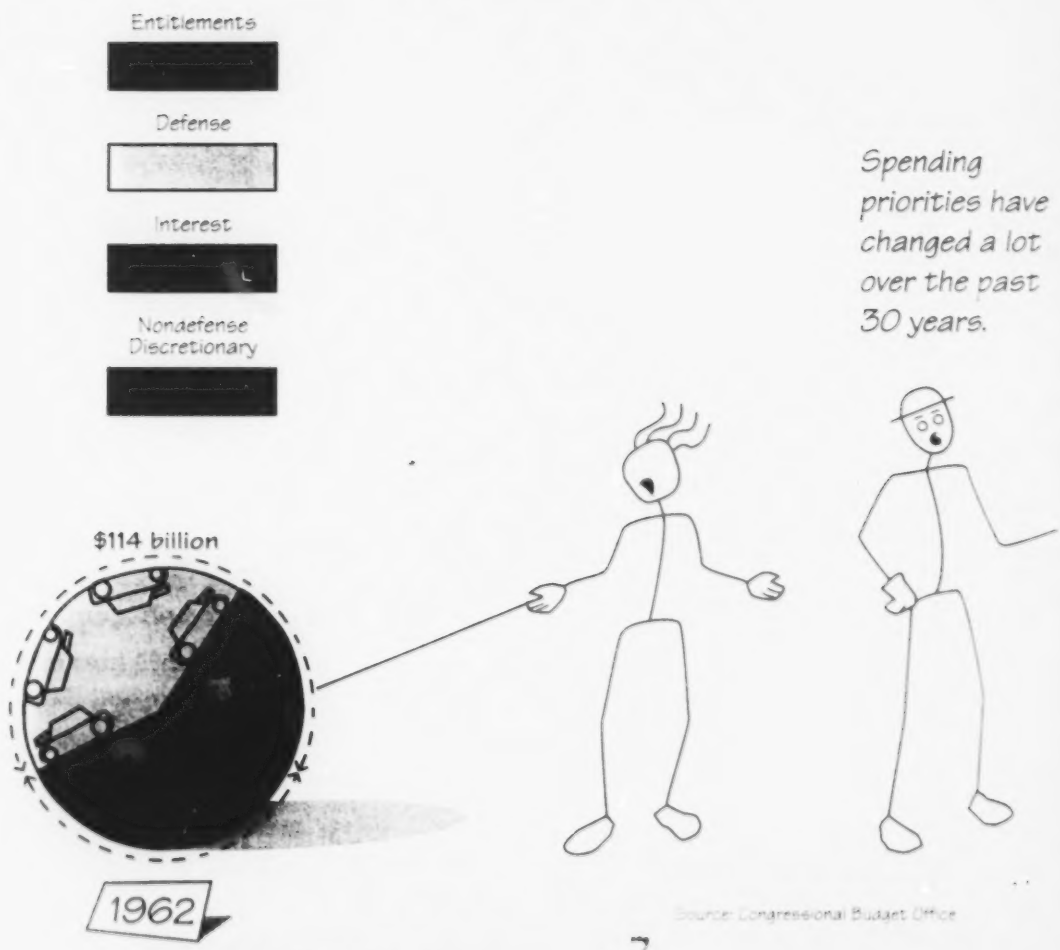
Anything else?

In addition, the inflation and high interest rates of the 1970s and early 1980s contributed to the rapidly growing debt. Even with inflation and interest rates declining in recent years, the debt has not been reduced, because spending has continued to outpace revenues.

Has the debt always been rising?

The first great surge in the national debt was caused by U.S. participation in World War I. By the time the war ended in 1918, the debt had increased from a little over $1 billion to about $15 billion.

The second surge took place during the Great Depression. There was high unemployment and, therefore, less taxable income. New social programs meant that the government had to borrow in order to finance increased spending. As a result, the debt climbed to almost $50 billion by the start of World War II.



Spending priorities have changed a lot over the past 30 years.

Source: Congressional Budget Office

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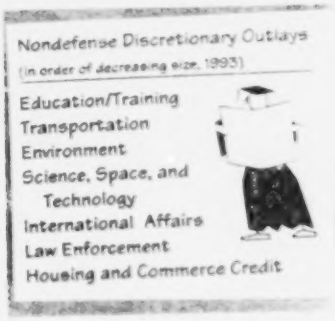
What about World War II and since?

The costs of the war drove the total U.S. debt to more than $250 billion. But the debt hardly grew at all for the next quarter century. In the late 1960s, though, spending increases due to the Vietnam War and new social programs put the government deeper in debt. After 1981, deficits increased very sharply. Tax cuts reduced revenue, while spending grew rapidly for entitlement programs such as Social Security and Medicare and, to a lesser extent, for national defense.



1992

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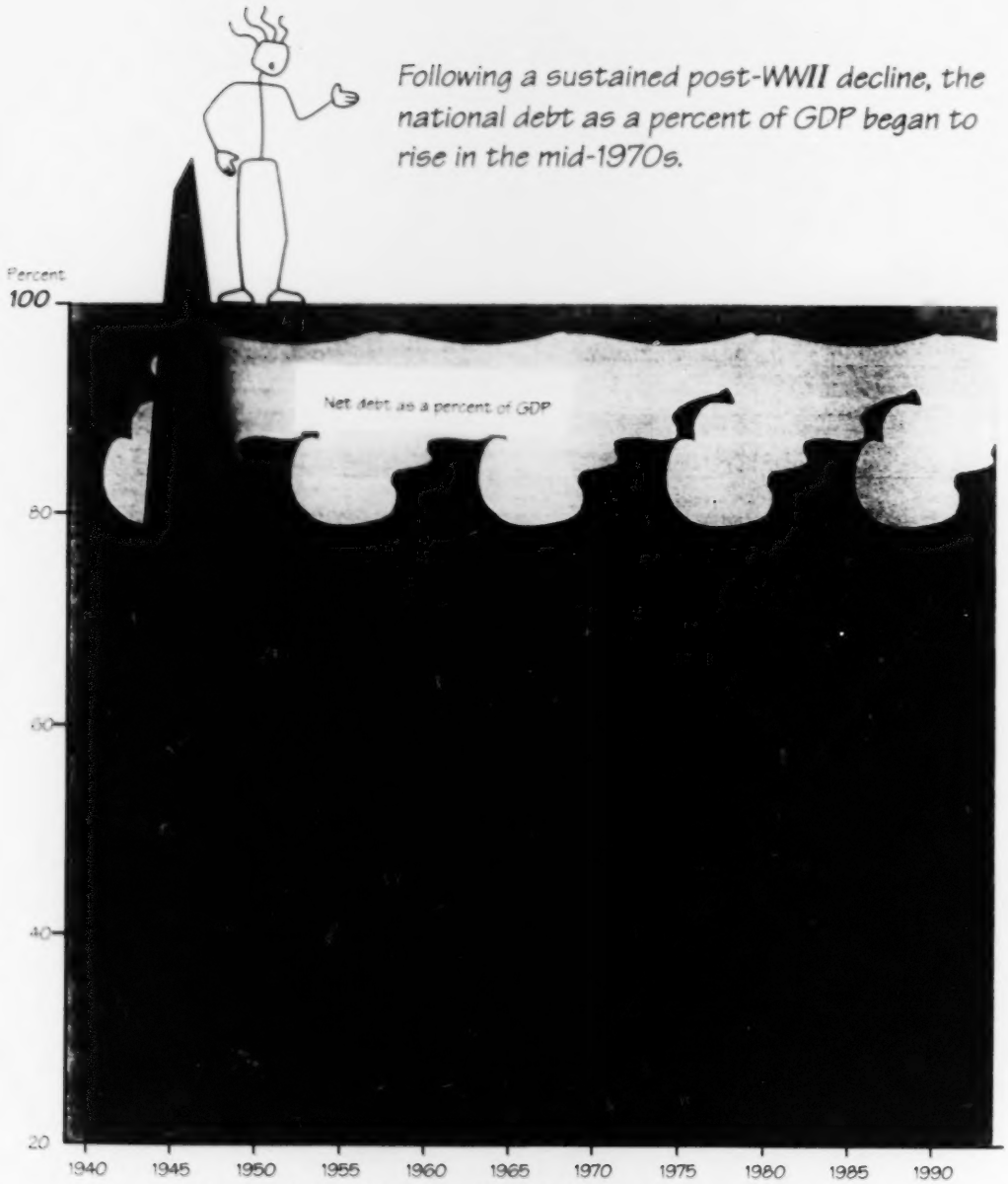
But even so, is today's debt really so large? Isn't the economy much larger today? Can't we handle more debt?

A larger economy can handle more debt. To get some perspective, economists often compare the debt with the total market value of the goods and services the nation produces each year — the gross domestic product, or "GDP." This is done to show the flow of total income from which the government can derive its revenue. Just after WWII, the net national debt was approximately equal to GDP. In 1975, it was down to about one quarter of GDP, but by 1993, it had climbed back to a little over half.



Following a sustained post-WWII decline, the national debt as a percent of GDP began to rise in the mid-1970s.

Sources: Federal Reserve Bank of New York; Economic Report of the President

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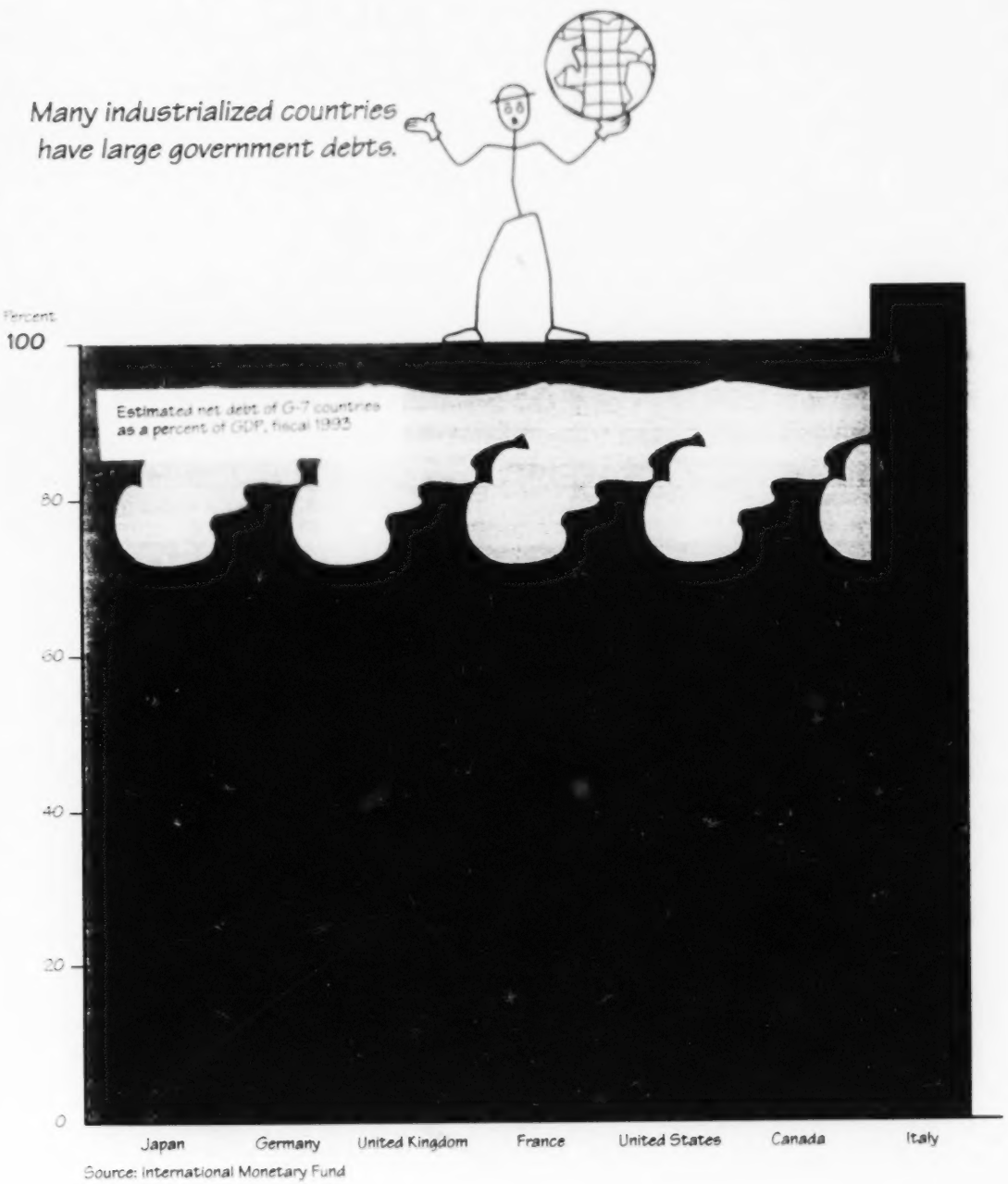
Is there a limit as to how high the debt can go?

There is a ceiling, but Congress and the President periodically approve legislation to raise it, allowing the federal government to borrow more money.

Do other countries have debts as large as ours?

Not if you look at the absolute size of the debt. But other highly industrialized countries have debts of comparable size in relation to GDP, and in fact, those of Italy and Canada are larger.



Source: International Monetary Fund

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What about our deficit in relation to GDP? Does it stay pretty constant?

Typically, the deficit increases as a percent of GDP during business slumps, as government spending for social programs increases and tax revenues lag. In theory, during periods of expansion, the deficit should fall as a share of GDP, or even turn into a surplus. However, this hasn't been the case recently.

Why not?

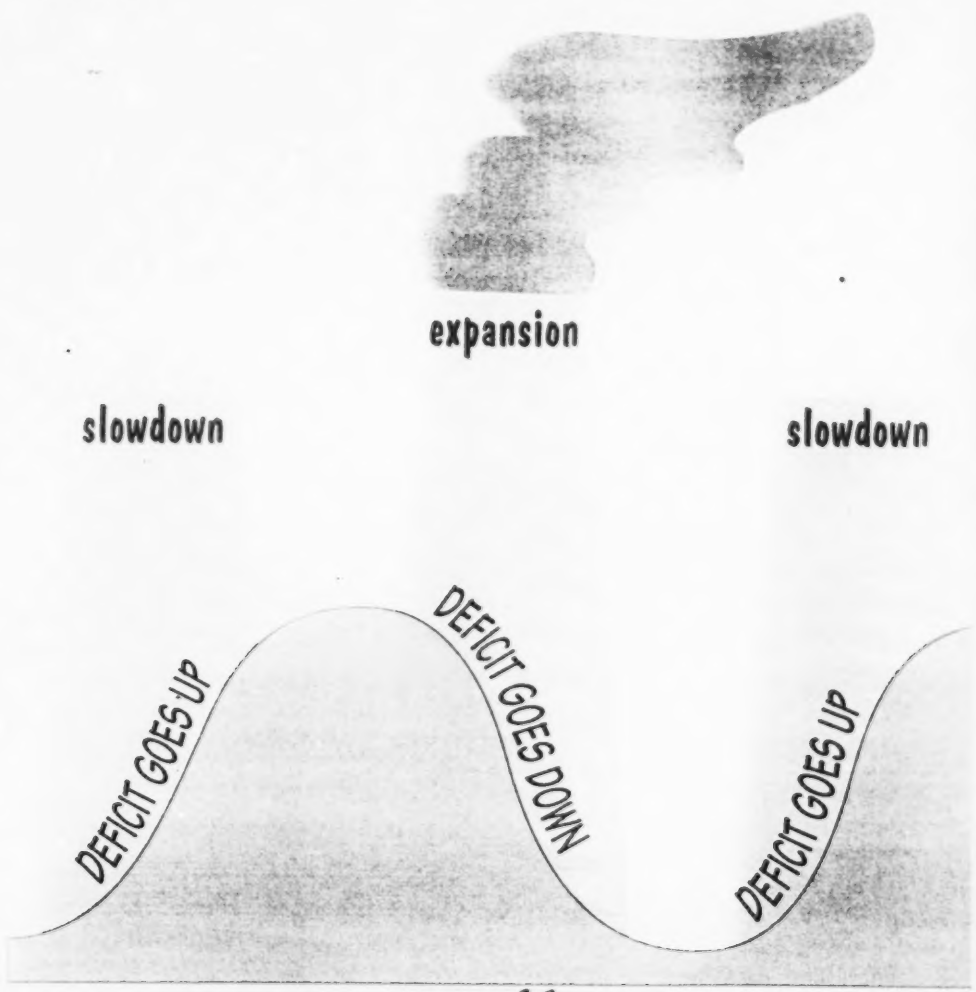
The cyclical component of the deficit has been falling and the structural component has been rising.

Whoa. Slow down. This pamphlet is supposed to be an introduction to the topic, not a Ph.D. dissertation. Now, what do you mean by cyclical and structural components?

The structural deficit is what the deficit would be if the economy were operating at full employment. The cyclical component is the part of the deficit that is driven by the business cycle.

Run that by me again?

Sure. Spending and revenue that vary in response to economic conditions make up the cyclical component of the deficit. For instance, if business is booming, personal and corporate income both rise, generating higher tax revenue. And with unemployment falling, government spending for unemployment compensation and other social programs falls, so the cyclical component shrinks. However, if the economy is slowing or in recession, tax revenues decline and outlays go up, and the cyclical component of the deficit grows.



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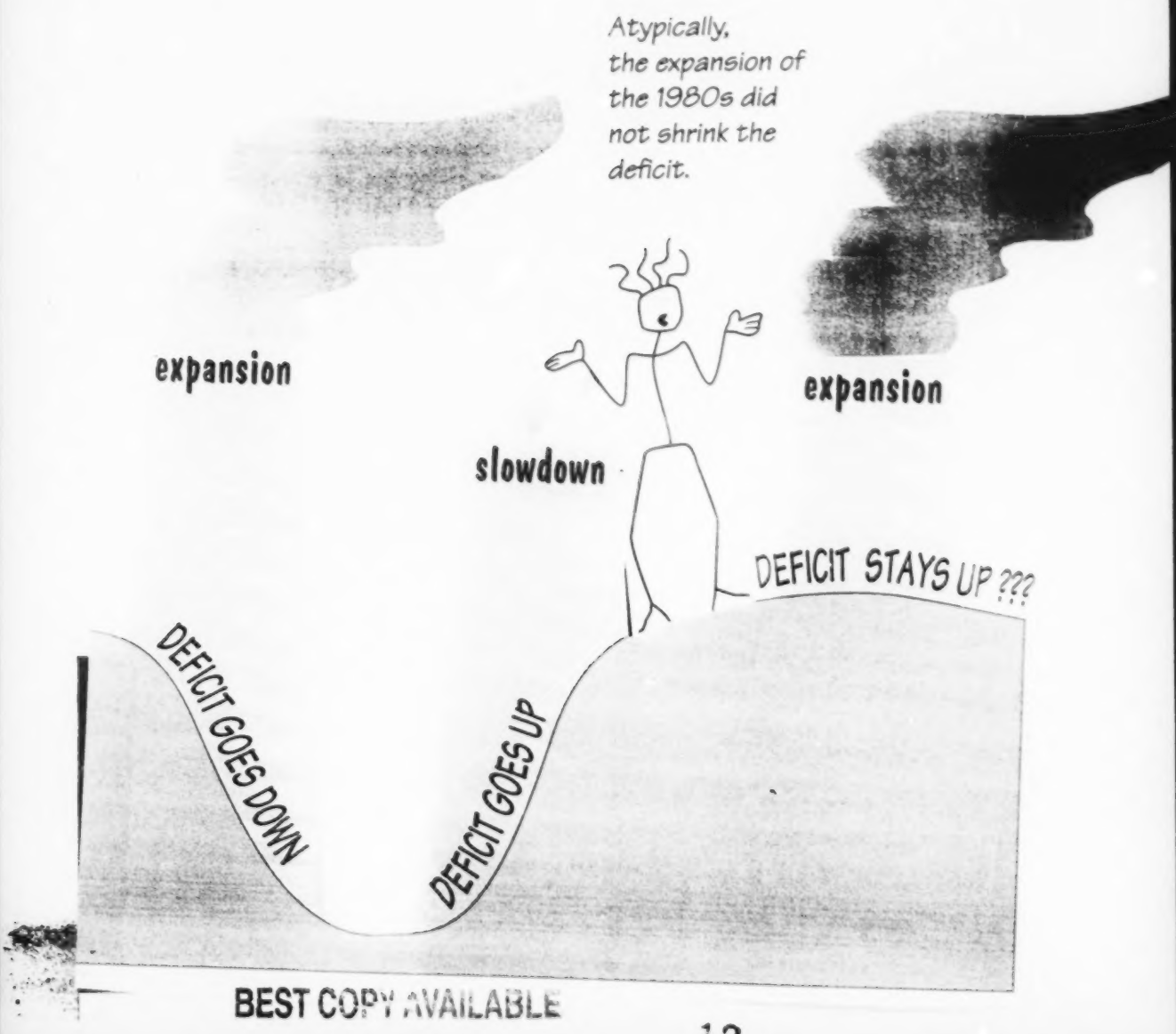
What about the structural component?

Well, there are some parts of the budget that are not as sensitive to changes in the rate of economic growth. Two good examples are spending for Social Security and interest on the debt, which aren't significantly affected by unemployment and economic growth. Over the past decade, such "structural" items have become more important in the overall budget. Because of this, even if the economy were operating at full employment and spending on cyclically sensitive programs were relatively low, total spending still would exceed total tax revenue, leaving us with a deficit.

I understand the economy affects the deficit. Does the deficit influence the economy?

Absolutely. It's a two-way street: the economy affects the budget, and the budget affects the economy. For example, raising or lowering taxes can influence people's spending and saving decisions, while government spending can influence interest rates and economic growth.



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So we keep running deficits and piling up debt. Should we be worried?

It's definitely cause for concern. There are a number of serious economic problems that are caused or aggravated by constantly running deficits and incurring a huge debt.

What's the biggest problem caused by the debt?

Large amounts of government borrowing can "crowd out" private investment as budget deficits exert upward pressure on interest rates. If the government borrows large amounts of money, there is less for everyone else, and interest rates tend to rise. Some private borrowers might not be able to afford the higher rates. Of course, many other factors besides deficits influence interest rates, such as the growth rate of the economy and expectations for inflation. For instance, the debt grew rapidly in the early 1990s, but many interest rates dropped to 30-year lows. Still, "real" interest rates, interest rates after inflation is subtracted, remained relatively high.

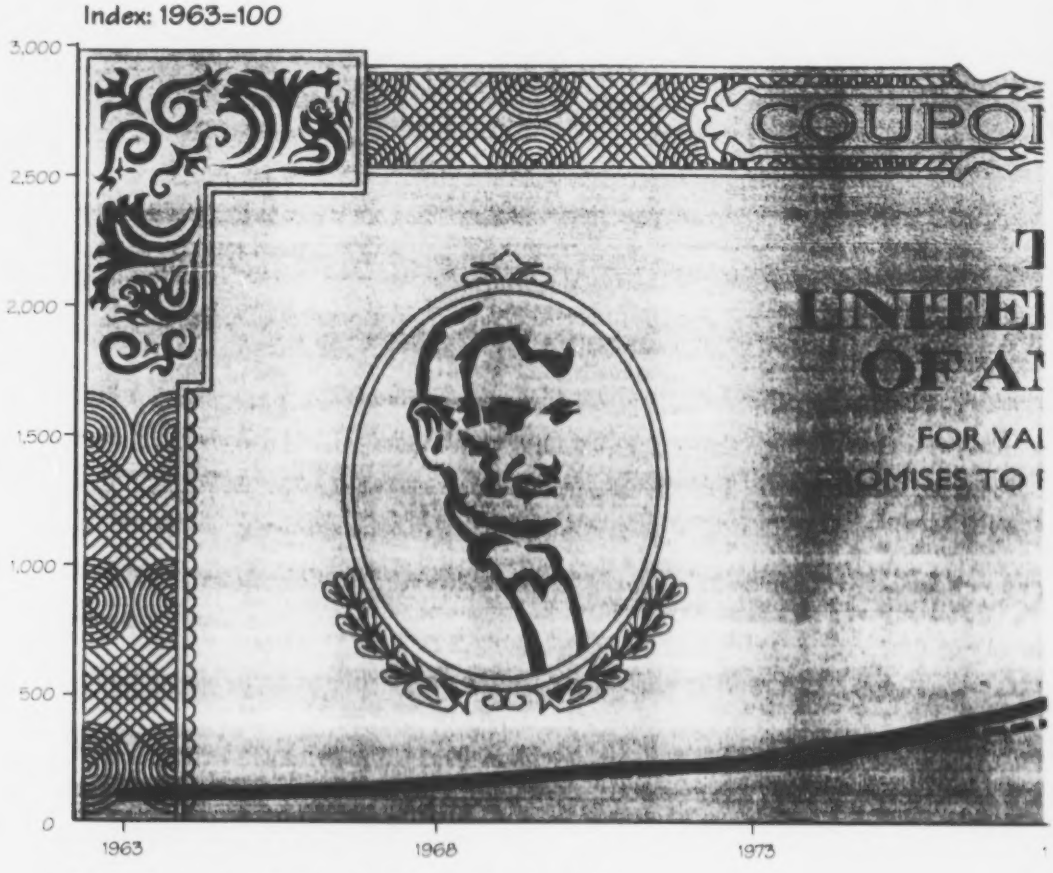
And that makes it more expensive for people and businesses to borrow?

Right, and to the extent that deficits lead to less business investment, there will be slower growth in the future. In other words, future living standards will be lower if there is less investment now.

On the other hand, some argue that relatively high interest rates have a self-correcting "crowding in" effect; foreigners find dollar investments attractive, and savings flow into the country from abroad. This may alleviate the higher rates.

That sounds good.

Like many other things in economics, it is and it isn't. You're correct about foreigners supplementing our savings with theirs. That has helped stabilize our interest rates and has spurred economic growth.



Sources: Federal Reserve Bank of New York; Congressional Budget Office

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So what's the problem?

Well, debt held by foreigners, or "external debt," does present a burden, since it represents claims on future U.S. production. In addition, the interest payments that are sent abroad are not necessarily reinvested in the United States.

Sounds like we shouldn't borrow at all.

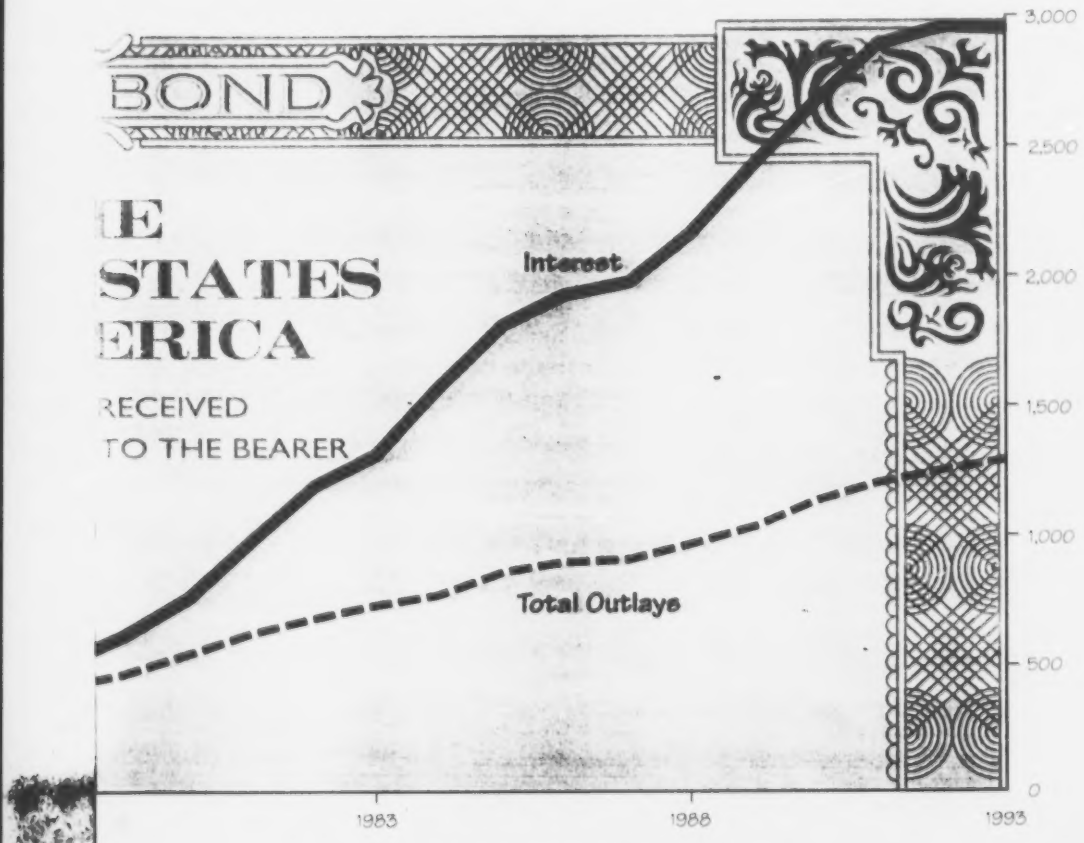
It depends on why we borrow. Think for a minute about why you might borrow. For instance, if you go into debt to pay for a college education, that's an investment; you'll probably get a return on your money by increasing your earning power. Similarly, if the federal government goes into debt to invest in productive capacity, such as capital goods, training, or new technology, the economy might grow faster than the burden of debt.

Is this what has, in fact, happened?

Unfortunately, no. A lot of the current government spending that is driving the growth of the debt, such as health care programs and Social Security, is for consumption, not investment. Investment leads to long-term economic growth, while consumption provides only a short-term boost. So, by going into debt to pay for consumption,we divert funds from "discretionary" programs, like investment in research and infrastructure, that might be engines for growth. The result is that our ability to produce competitive goods and services isn't growing as fast as it could. This ultimately means lower living standards than we might otherwise enjoy.

How large are the interest payments on the debt?

In 1992, interest on the debt amounted to nearly $200 billion, or 18 percent of federal government revenue. That was up from 10 percent in 1980 and 7 percent in 1970. Interest on the debt is now the third largest item in the federal budget. The two largest are Social Security and national defense.



Interest expenditures have grown much faster than overall government spending since the late 1970s.

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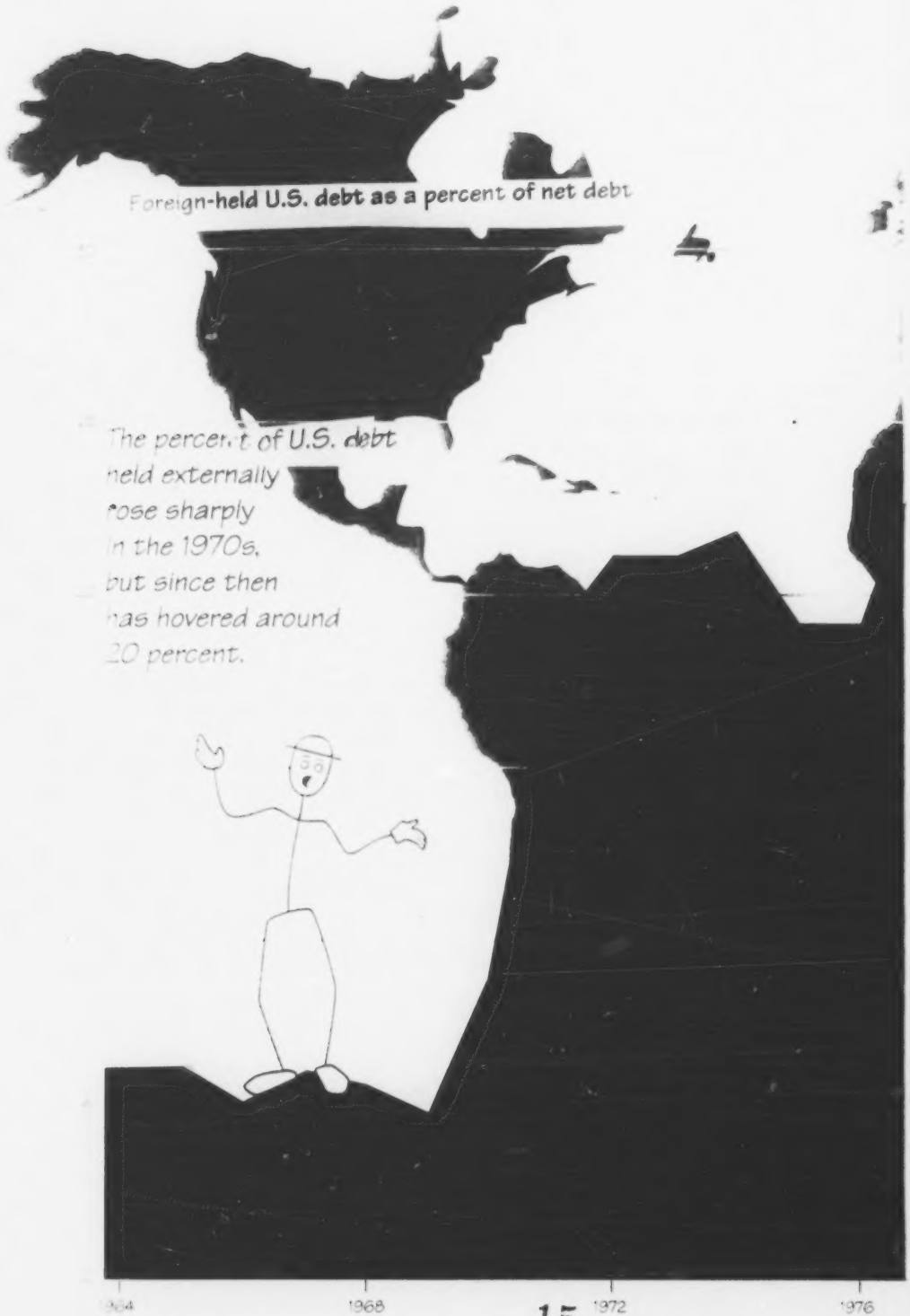
What other problems does the debt cause?

One other important issue concerns our external debt. As of June 1993, $568 billion of privately held debt was owned by foreigners. When the United States draws funds from abroad, one of two results might follow: foreign interest rates might rise, reducing foreigners' domestic investment and hampering their economic growth, or the value of the dollar might increase. Either of these events might cut the demand for our exports.


Foreign-held U.S. debt as a percent of net debt
The percent of U.S. debt held externally rose sharply in the 1970s, but since then has hovered around 20 percent.
1964
1968
1972
1976

Sources: Federal Reserve Bank of New York; U.S. Treasury

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And when U.S. exports decline, that can increase our unemployment rate, reduce our tax base, and increase government expenditures for unemployment insurance?

Don't interrupt. You're right, though. The combined effect could be to worsen the federal deficit.

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So persistent deficits can affect interest rates, investment, and economic growth?

Yes, and there's even more. Budget deficits might cause inflation. Since deficit spending stimulates demand for goods and services, prices can be driven up.

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Couldn't the government just create more money to pay off the debt?

No, it doesn't work that way. First of all, the federal government doesn't create money; that's one of the jobs of the Federal Reserve, our central bank. The Fed's monetary policy tries to influence the supply of money in the economy to promote noninflationary growth. Creating money to pay off the debt won't work. Unless there is an increase in economic activity commensurate with the amount of money that is created, inflation could get worse. There would be, as the saying goes, "too much money chasing too few goods."

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If the debt is such a problem, why haven't we reduced it? I guess we'd have to raise taxes or cut spending, right?

Right! But that's easier said than done. Many spending programs in the federal budget were set up in such a way that outlays for them occur automatically; these are the entitlements we talked about earlier. They're extremely difficult to trim.

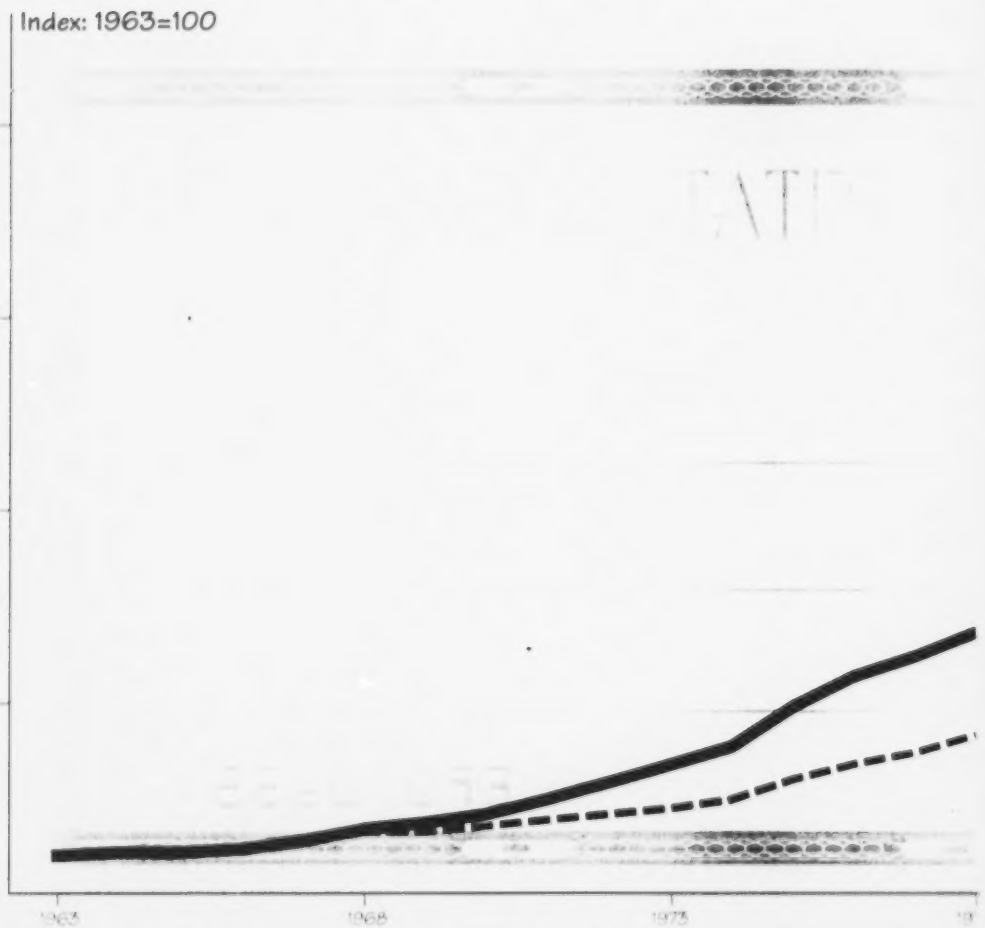
Why?

By law, programs like Medicare, Medicaid, Social Security, food stamps, and other entitlement programs must cover as many people as qualify for them, regardless of how much it costs. Of course, savings could be achieved by restricting eligibility for entitlements, but steps like that are bound to be very unpopular among people who are affected.

Besides entitlements, we don't have the option of reducing interest payments. In 1993, roughly two-thirds of government expenditures were non-discretionary, meaning the government had no choice but to pay.

What about raising taxes?

There's a lot of resistance to new or higher taxes. Besides, there are many who think that higher taxes reduce economic activity by taking spending power away from consumers and investment capital away from businesses. They believe the government deficit should be reduced primarily by cutting government spending.



Sources: Federal Reserve Bank of New York; Congressional Budget Office

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I remember hearing about the Gramm-Rudman Act a while ago. Wasn't that supposed to cut the deficit?

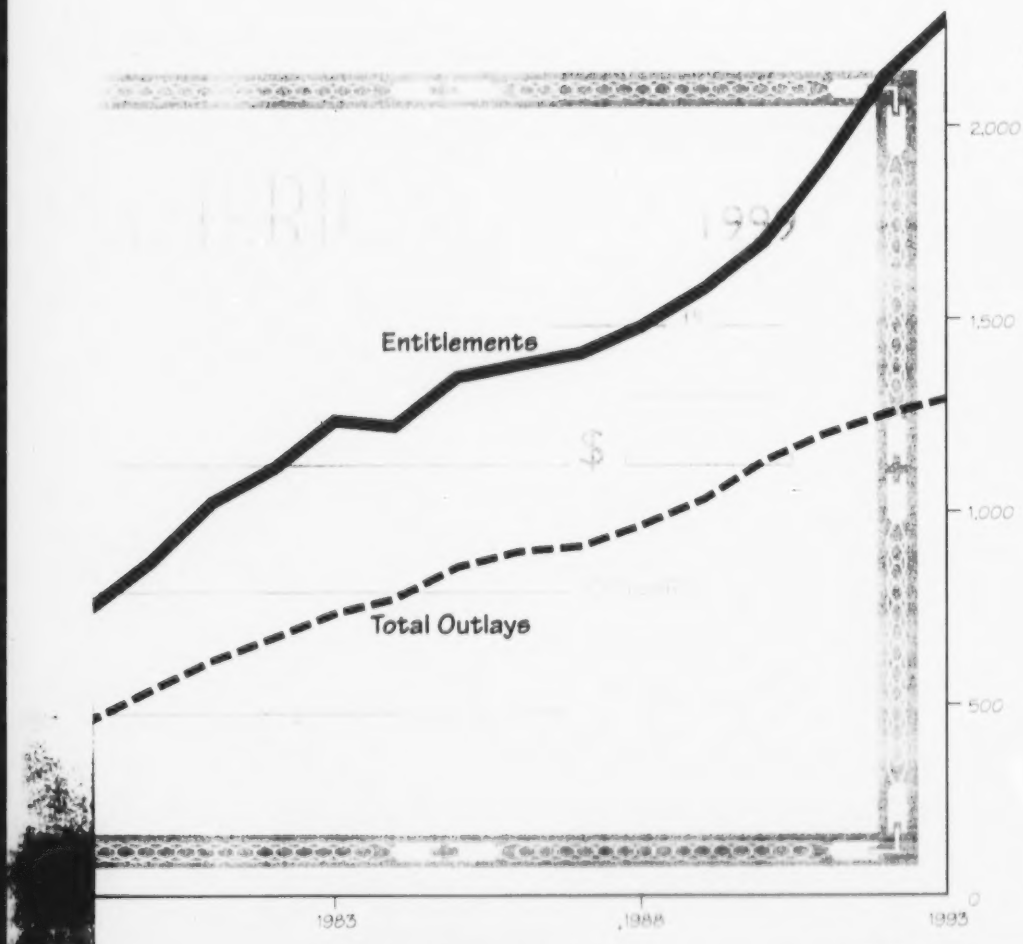
Yes. The Gramm-Rudman-Hollings Deficit Reduction Act was enacted in 1985 and was designed to balance the budget by 1991.

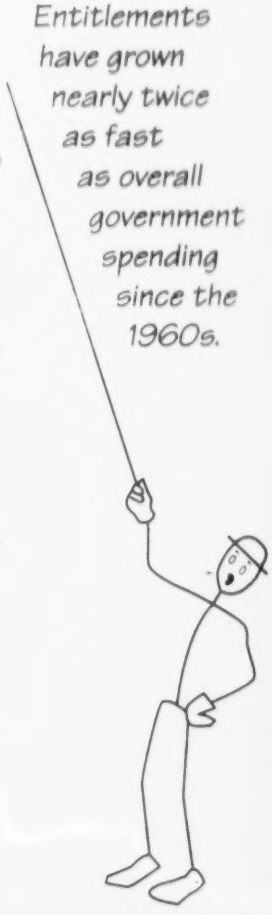
Why didn't it happen?

Gramm-Rudman set targets and required that the deficit projections by the Administration's Office of Management and Budget be within those targets. If the President and Congress couldn't agree on spending cuts and tax increases to bring the projected deficits down to Gramm-Rudman's targets, across-the-board cuts were supposed to be imposed automatically to bring the deficit down. The problem was that most projections relied on unrealistic assumptions about economic growth and federal revenues. This made the deficit projections look good enough to fit within the targets, but the final, actual numbers left the United States with large deficits.

Why couldn't we just get rid of the deficit problem by passing a law compelling the federal government to balance the budget?

As a matter of fact, some attempts have been made to do just that. One idea that has come before Congress is to propose a Constitutional amendment that would require Congress to balance the budget every year. Of course, even with such a requirement, difficult decisions about which taxes to raise and which programs to cut would still remain.





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What other attempts have been made to reduce the debt?

In 1990, Congress passed the Budget Enforcement Act (BEA). This placed limits, or caps, on spending for defense and other discretionary spending. The BEA was enacted along with a legislative package that provided almost $500 billion of deficit reduction over five years and imposed automatic cuts and pay-as-you-go (PAYGO) requirements. PAYGO provided that laws requiring new spending would have to specify where the funds to pay for the spending would come from.

That sounds like it would work! So why is the deficit still so big?

The main reason is that entitlement spending — by far the fastest growing sector — wasn't cut enough to stop its growth. Besides, other factors haven't helped.

Such as?

A sluggish economy, for one thing. Tax revenues in the early 1990s fell well short of BEA projections, and spending for unemployment and welfare programs rose. In addition, there were big automatic increases in spending for Medicaid and Medicare. Finally, even though interest rates have come down, the total interest paid on the ever-increasing debt continues to rise. All these things exacerbate a budget imbalance.

What about the 1993 plan?

Congress passed a five-year plan of tax increases and spending cuts designed to reduce the debt by around $500 billion.

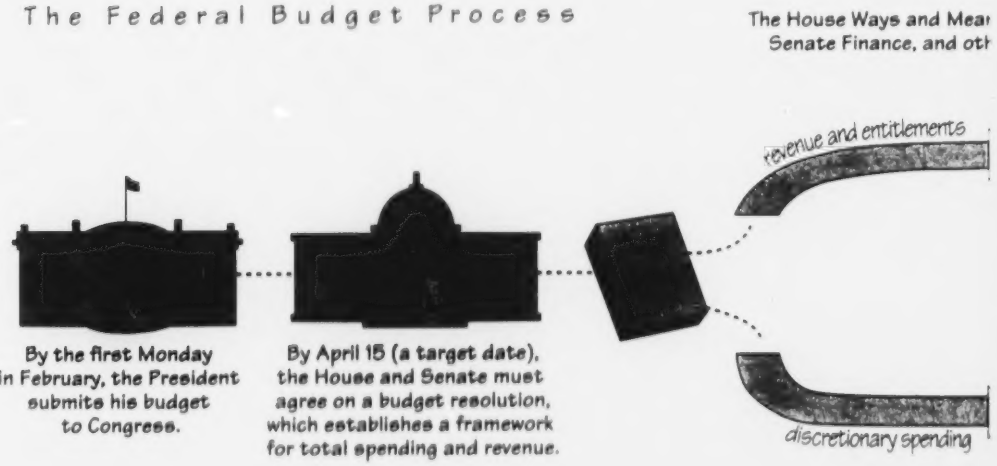
How?

The top personal and corporate tax rates were raised, and taxes were added on Social Security benefits and fuels. All wages and salaries, not just those up to $135,000, became subject to Medicare taxes, and cuts were made in expenditures for medical care, federal pensions, and many other areas. A freeze was established on discretionary spending. Despite the 1993 budget plan, however, the deficit remains large.

How does the government make decisions on spending?

The federal budget process is pretty complicated. Basically, by the first Monday in February, the President presents the Administration's budget proposal to Congress, requesting funding for every program in the federal government. Then, by April 15...

The Federal Budget Process



By the first Monday in February, the President submits his budget to Congress.

By April 15 (a target date), the House and Senate must agree on a budget resolution, which establishes a framework for total spending and revenue.

The House Ways and Mean Senate Finance, and oth

The Appropriations Committ in each chamber divides discretiona

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Wait! Who actually makes budget decisions?

The President proposes a budget, but Congress needs to authorize all government spending. However, the President can veto spending bills, just like any other legislation.

Okay. So by April 15...

Well, that's actually only a target date, not set in stone. The House and the Senate must agree on a budget resolution, which may increase or decrease the amounts in the President's proposal. Then the Appropriations Committee in each chamber divides the proposals for discretionary spending among its 13 subcommittees. At the same time, other committees, mainly the House Ways and Means Committee and the Senate Finance Committee, grapple with the revenue and entitlement portions of the budget.

Let me get this straight. There's a House Appropriations Committee with 13 subcommittees and a Senate Appropriations Committee with 13 subcommittees? And that's just for discretionary spending?

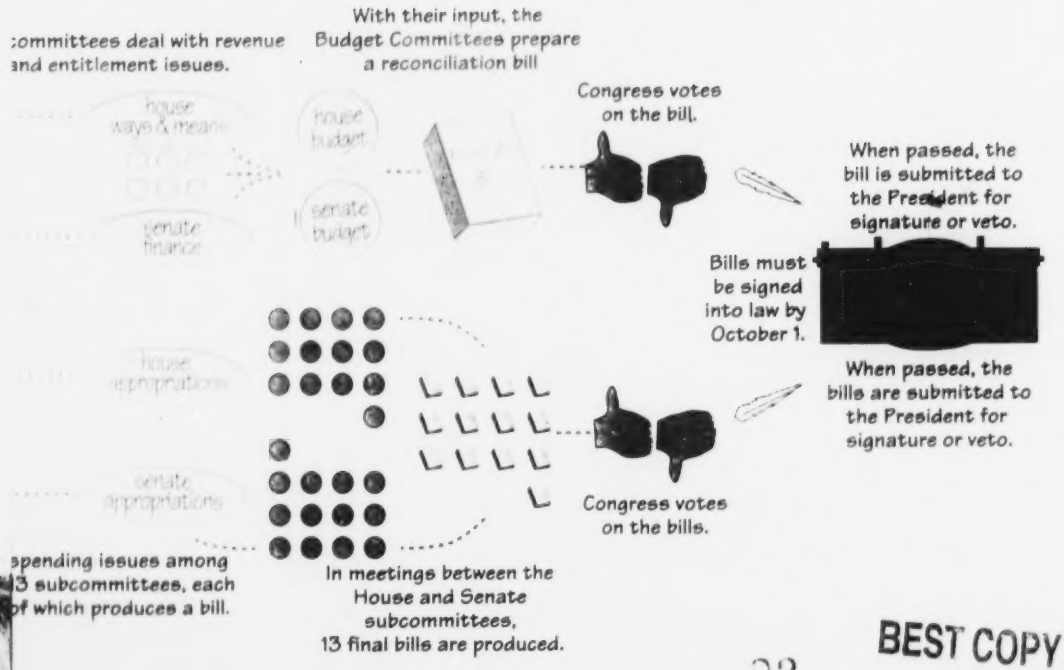
Yes. Each subcommittee produces a spending bill and then the pairs of subcommittees, one each from the House and Senate, meet to finalize the bills. After Congressional approval, the 13 final bills go to the President for signature or veto. In addition, the House and Senate Budget Committees send the President a "reconciliation" bill. This bill draws on a number of committees, chiefly the House Ways and Means and Senate Finance Committees, that have jurisdiction over taxes and entitlement spending. The deadline for the whole process is October 1, when the new fiscal year starts.

What happens if Congress misses the deadline?

Congress has to pass continuing resolutions, which are short-term spending decisions to keep the government running. In fact, throughout fiscal 1987 and 1988, the federal government operated entirely under continuing resolutions—though that's unusual.

What happens if that legislation isn't passed?

The government runs out of funds and shuts down. It's happened for short periods.


committees deal with revenue and entitlement issues.
With their input, the Budget Committees prepare a reconciliation bill
Congress votes on the bill.
When passed, the bill is submitted to the President for signature or veto.
Bills must be signed into law by October 1.
When passed, the bills are submitted to the President for signature or veto.
Congress votes on the bills.
spending issues among 13 subcommittees, each of which produces a bill.
In meetings between the House and Senate subcommittees, 13 final bills are produced.

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Now that I grasp the concepts of the debt and deficit and some of the problems they cause, are you telling me that there's really nothing one can do?

Not at all! What I'm saying is that there are tough choices that have to be made and there aren't any magic numbers or proportions to tell us the right size for federal spending, taxing, and the deficits that might arise. As we have seen, deficits have the potential to cause serious economic problems.

Well, what should we do?

That's for you and the rest of the public to decide.

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